



# CALIFORNIA STATE AUDITOR

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## *Independent Auditor's Report*

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THE GOVERNOR AND THE LEGISLATURE OF THE  
STATE OF CALIFORNIA

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of and for the year ended June 30, 2005, which collectively comprise the State of California's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the State of California's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the following significant amounts in the financial statements of:

### Government-wide Financial Statements

- Certain enterprise funds that, in the aggregate, represent 85 percent, 49 percent, and 51 percent, respectively, of the assets, net assets, and revenues of the business-type activities.
- The University of California, State Compensation Insurance Fund, California Housing Finance Agency, Public Employees' Benefits, and certain other funds that, in the aggregate, represent over 99 percent of the assets, net assets, and revenues of the discretely presented component units.

### Fund Financial Statements

- The following major enterprise funds: Electric Power fund, Water Resources fund, Public Building Construction fund, and State Lottery fund.
- Certain nonmajor enterprise funds that represent 87 percent, 78 percent, and 85 percent, respectively, of the assets, net assets, and revenues of the nonmajor enterprise funds.
- The funds of the Public Employees' Retirement System, State Teachers' Retirement System, and the University of California Retirement System that, in the aggregate, represent 92 percent, 94 percent, and 70 percent, respectively, of the assets, net assets and additions of the fiduciary funds and similar component units.
- The discretely presented component units noted above.

Those financial statements were audited by other auditors whose reports have been furnished to us, and our opinions, insofar as they relate to the amounts included for those funds and entities, is based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts

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## BUREAU OF STATE AUDITS

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and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit and the reports of other auditors provide a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the State of California, as of June 30, 2005, and the respective changes in financial position and cash flows, where applicable, thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, reports on the State's internal control structure and on its compliance with laws and regulations will be issued in our single audit report. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The management's discussion and analysis, schedule of funding progress, infrastructure information, budgetary comparison information, reconciliation of budgetary and GAAP-basis fund balances and related notes are not a required part of the basic financial statements but are supplementary information required by the Governmental Accounting Standards Board. We and the other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the State of California's basic financial statements. The combining financial statements listed in the accompanying table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The combining financial statements have been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, based on our audit and the reports of other auditors, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory and statistical sections of this report have not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we express no opinion on them.

BUREAU OF STATE AUDITS



PHILIP J. JELICICH, CPA  
Deputy State Auditor

February 28, 2006

## NOTE 3: DEPOSITS AND INVESTMENTS

The State reports its investments at fair value. State statutes authorize investments in certain types of securities. The State Treasurer administers a single pooled investment program comprising both an internal investment pool and an external investment pool (the Local Agency Investment Fund). A single portfolio of investments exists, with all participants having an undivided interest in the portfolio. Both pools are administered in the same manner, as described below. In addition, certain funds have the authority to separately invest their cash.

The State of California has implemented GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, for the year ended June 30, 2005. This statement required the disclosure of the following risks to the extent that they exist at the date of the statement of net assets:

### *Interest Rate Risk*

Interest rate risk is the risk that the value of fixed income securities will decline because of changing interest rates. The prices of fixed income securities with longer time to maturity tend to be more sensitive to changes in interest rates than those with shorter durations.

### *Credit Risk*

Credit risk is the risk that a debt issuer will fail to pay interest or principal in a timely manner, or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline.

### *Custodial Credit Risk*

Custodial credit risk is the risk that, in the event a financial institution or counterparty fails, the investor will not be able to recover the value of its deposits, investments, or collateral.

*Concentration of Credit Risk*

Concentration of credit risk is the risk of loss attributed to the magnitude of an investor's holdings in a single issuer.

*Foreign Currency Risk*

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or a deposit.

## A. Primary Government

The State's pooled investment program and certain funds of the primary government are allowed by state statutes, bond resolutions, and investment policy resolutions to have investments in United States government securities, Federal agency securities, negotiable certificates of deposit, bankers' acceptances, commercial paper, corporate bonds, bank notes, other debt securities, repurchase agreements, reverse repurchase agreements, and other investments.

The State Treasurer's Office administers a pooled investment program for the primary government and for certain discretely presented component units. As of June 30, 2005, the discretely presented component units accounted for approximately 3.6% of the State Treasurer's pooled investment portfolio. This program enables the State Treasurer's Office to combine available cash from all funds and to invest cash that exceeds current needs.

Both deposits and investments are included in the State's investment program. For certain banks, the State Treasurer's Office maintains cash deposits that cover uncleared checks deposited in the State's accounts and that earn income which compensates the banks for their services.

Demand and time deposits held by financial institutions as of June 30, 2005, totaling approximately \$7.6 billion, were insured by federal depository insurance or by collateral held by the State Treasurer's Office or an agent of the State Treasurer's Office in the State's name. The California Government Code requires that collateral pledged for demand and time deposits be deposited with the State Treasurer.

As of June 30, 2005, the State Treasurer's Office had amounts on deposit with a fiscal agent totaling \$30 million related to principal and interest payments to bondholders. Additionally, \$11 million was in a compensating balance account with a custodial agent that was designed to provide sufficient earnings to cover fees for custodial services. These deposits are insured by federal depository insurance or by collateral held by an agent of the State Treasurer's Office in the State's name.

The State Treasurer's Office reports its investments at fair value. The fair value of securities in the State Treasurer's pooled investment program generally is based on quoted market prices. As of June 30, 2005, the weighted average maturity of the securities in the pooled investment program administered by the State Treasurer's Office was approximately 133 days. Weighted average maturity is the average number of days, given a dollar-weighted value of individual investments, that the securities in the portfolio have remaining from evaluation date to stated maturity.

The Pooled Money Investment Board provides oversight of the State Treasurer's pooled investment program. The purpose of the board is to design an effective cash management and investment program, using all monies flowing through the State Treasurer's Office bank accounts and keeping all available funds invested in a manner consistent with the goals of safety, liquidity, and yield. The Pooled Money Investment Board is comprised of the State Treasurer as chair, the State Controller, and the Director of Finance. This board



designates the amounts of money available for investment. The State Treasurer is charged with making the actual investment transactions for this program. This investment program is not registered with the Securities and Exchange Commission as an investment company.

The value of the deposits in the State Treasurer's pooled investment program, including the Local Agency Investment Fund, is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2005, this difference was immaterial to the valuation of the program. The pool is run with "dollar-in, dollar-out" participation. There are no share-value adjustments to reflect changes in fair value.

Certain funds have elected to participate in the pooled investment program, even though they have the authority to make their own investments. Others may be required by legislation to participate in the program. As a result, the deposits of these funds or accounts may be considered involuntary. However, these funds or accounts are part of the State's reporting entity. The remaining participation in the pool, the Local Agency Investment Fund, is voluntary.

Certain funds that have deposits in the State Treasurer's pooled investment program do not receive the interest earnings on their deposits. Instead, by law, the earnings are to be assigned to the State's General Fund. Some of the \$233 million in interest revenue received by the General Fund from the pooled investment program in the 2004-05 fiscal year was earned on balances in these funds.

The State Treasurer's pooled investment program values participants' shares on an amortized cost basis. Specifically, the program distributes income to participants quarterly, based on their relative participation during the quarter. This participation is calculated based on (1) realized investment gains and losses calculated on an amortized cost basis, (2) interest income based on stated rates (both paid and accrued), (3) amortization of discounts and premiums on a straight-line basis, and (4) investment and administrative expenses. This amortized cost method differs from the fair value method used to value investments in these financial statements; the amortized cost method is not designed to distribute to participants all unrealized gains and losses in the fair value of the pool's investments. Because the total difference between the fair value of the investments in the pool and the value distributed to pool participants using the amortized cost method described above is not material, no adjustment was made to the financial statements.

The State Treasurer's Office also reports participant fair value as a ratio of amortized cost on a quarterly basis. The State Treasurer's Office has not provided or obtained a legally binding guarantee to support the principal invested in the investment program.

As of June 30, 2005, structured notes and asset-backed securities comprised slightly more than 2.4% of the pooled investments. A significant portion of the asset-backed securities consists of small-business loans and mortgage-backed securities. The small-business loans held in the portfolio are guaranteed by the Small Business Administration, an agency of the federal government. The mortgage-backed securities, which are called real estate mortgage investment conduits (REMICs), are securities backed by pools of mortgages. The REMICs in the State's portfolio have a fixed principal payment schedule. A portion of the asset-backed securities consisted of floating-rate notes. For floating-rate notes held in the portfolio during the fiscal year, the interest received by the State Treasurer's pooled investment program rose or fell as the underlying index rate rose or fell. The structure of the floating-rate notes in the State Treasurer's pooled investment program portfolio hedged the portfolio against the risk of increasing interest rates.

Enterprise funds and special revenue funds also make separate investments, which are presented at fair value.

Table 1 identifies the investment types that are authorized by the California Government Code and the State Treasurer's Office investment policy for the pooled investment program.

**Table 1****Authorized Investments**

<b>Authorized Investment Type</b>	<b>Maximum Maturity</b>	<b>Maximum Percentage of Portfolio</b>	<b>Maximum Investment in One Issuer</b>	<b>Credit Rating</b>
U.S. Treasury Securities	5 years*	N/A**	N/A**	N/A**
Federal Agency Securities	5 years*	N/A**	N/A**	N/A**
Certificates of Deposit	5 years*	N/A**	N/A**	N/A**
Bankers Acceptances	180 days*	N/A**	N/A**	N/A**
Commercial Paper	180 days	30%	10% of issuer's outstanding Commercial Paper	A-2/P-2/F-2***
Corporate Bonds/Notes	5 years*	N/A**	N/A**	A/A/A****
Repurchase Agreements	1 year*	N/A**	N/A**	N/A**
Reverse Repurchase Agreements	1 year*	10%*	N/A**	N/A**

\* Limitations are pursuant to the State Treasurer's Office Investment Policy for the Pooled Money Investment Account. The Government Code does not establish limits for investments of surplus moneys in this investment type.

\*\* N/A = Neither the Government Code nor the State Treasurer's Office Investment Policy for the Pooled Money Investment Account sets limits for the investment of surplus moneys in this investment type.

\*\*\* The State Treasurer's Office Investment Policy for the Pooled Money Investment account is more restrictive than the Government Code, which allows investments rated A-3/P-3/F-3.

\*\*\*\* The Government Code requires that a security be within the top three ratings of a nationally recognized rating service.

## 1. Interest Rate Risk

Table 2 presents the interest rate risk of the primary government's investments.

**Table 2****Schedule of Investments – Primary Government – Interest Rate Risk**

June 30, 2005

(amounts in thousands)

	<b>Interest Rates*</b>	<b>Maturity</b>	<b>Fair Value at Year End</b>	<b>Weighted Average Maturity ( in years)</b>
<b>Pooled investments</b>				
U.S. Treasury bills and notes .....	1.50 – 3.45	46 days - 1.42 years	\$ 5,680,299	0.58
U. S. Agency bonds and discount notes .....	1.36 – 3.95	5 days - 2.2 years	13,321,547	0.61
Small Business Administration loans .....	3.05 – 3.88	.25 year	718,199	0.25 **
Mortgage-backed securities # .....	3.92 – 14.25	1 day - 5 years	531,822	1.98
Certificates of deposit .....	2.80 – 3.51	1 day - .42 year	14,434,037	0.16
Commercial paper .....	2.87 – 3.42	1 day - .42 year	10,591,838	0.10
Corporate bonds and notes .....	1.44 – 6.48	1 day - 1.96 years	2,894,788	0.48 ***
<b>Total pooled investments .....</b>			<b>48,172,530</b>	
<b>Other primary government investments</b>				
U.S. Treasuries and agencies .....			2,736,231	6.05
Commercial paper .....			458,459	N/A ****
Guaranteed investment contracts .....			722,773	16.10
Corporate debt securities .....			155,718	2.09
Other .....			228,859	2.12
<b>Total other primary government investments .....</b>			<b>4,302,040</b>	
<b>Funds outside primary government included in pooled investments</b>				
Less: investment trust funds .....			18,662,977	
Less: other trust and agency funds .....			2,380,312	
Less: discretely presented component units .....			2,193,105	
<b>Total primary government investments .....</b>			<b>\$ 29,238,176</b>	

\* These numbers represent high and low interest rates for each investment type.

\*\* In calculating SBA holdings' weighted average maturity, the State Treasurer's Office assumes stated maturity is the quarterly reset date.

\*\*\* For corporate bond floating rate securities, the State Treasurer's Office assumes final maturity date in calculating weighted average maturity.

\*\*\*\* These commercial paper holdings of the Golden State Tobacco Securitization Corporation mature in less than 1 year.

# These securities are issued by U. S. government agencies such as the Federal National Mortgage Association.

Table 3 identifies the debt securities that are highly sensitive to interest rate fluctuations (to a greater degree than already indicated in the information provided previously).

**Table 3**

**Schedule of Highly Sensitive Investments in Debt Securities – Primary Government – Interest Rate Risk**

June 30, 2005

(amounts in thousands)

	<b>Fair Value at Year End</b>	<b>% of Total Pooled Investments</b>
<b>Pooled investments</b>		
Mortgage-backed		
Federal National Mortgage Association Collateralized Mortgage Obligations .....	\$ 529,282	1.099 %
Government National Mortgage Association Pools .....	356	0.001
Federal Home Loan Mortgage Corporation Participation Certificate Pools .....	2,184	0.005

These federal agency securities are mortgage-backed securities which entitle the purchaser to receive a share of the cash flows, such as principal and interest payments, from a pool of mortgages. Mortgage securities are sensitive to interest rate changes because principal payments either increase (in a low interest rate environment) or decrease (in a high interest rate environment). A change, up or down, in the payment rate will result in a change in the security yield.



## 2. Credit Risk

Table 4 presents the credit risk of the primary government's debt securities.

**Table 4****Schedule of Investments in Debt Securities – Primary Government – Credit Risk**

June 30, 2005

(amounts in thousands)

Credit Rating as of Year End		
Short-term	Long-term	Fair Value
Pooled investments*		
A-1+/P-1/F-1+	AAA/Aaa/AAA	\$ 33,209,023 **
A-1/P-1/F-1	AA/Aa/AA	7,001,755
A-2/P-2/F-2	A/A/A	884,641
	BB***	146,792
Not rated .....		531,466
Not applicable .....		6,398,853
Total pooled investments .....		\$ 48,172,530
Other primary government investments		
A-1+/P-1/F-1+	AAA/Aaa/AAA	\$ 1,106,401
A-1/P-1/F-1	AA/Aa/AA	273,282
A-2/P-2/F-2	A/A/A	133,512
Not rated .....		305,161
Not applicable .....		2,483,684
Total other primary government investments .....		\$ 4,302,040

\* The Treasurer's Office utilizes Standard & Poor's, Moody's, and Fitch ratings services. Securities are classified by the lowest rating of the three agencies.

\*\* This amount includes \$7.0 billion in Freddie Mac issued discount notes. Freddie Mac has not requested that all of its debt be rated, but all debt which has been rated received S&P's and Moody's top ratings.

\*\*\* This holding represents multiple maturities of one issuer, General Motors Acceptance Corporation. These securities were within the top three ratings of a nationally recognized rating service when purchased.

### 3. Concentration of Credit Risk

The investment policy of the State Treasurer's Office contains no limitations on the amount that can be invested in any one issuer beyond those limitations stipulated in the California Government Code. Table 5 identifies debt securities in any one issuer (other than U.S. Treasury securities) that represent 5% or more of the State Treasurer's investments, or of the separate investments of other primary government funds.

**Table 5**

**Schedule of Investments – Primary Government – Concentration of Credit Risk**

June 30, 2005

(amounts in thousands)

**POOLED INVESTMENTS**

<u>Issuer</u>	<u>Investment Type</u>	<u>Reported Amount</u>	<u>% of Total Pooled Investments</u>
Federal Home Loan Mortgage Corp.	U.S. agency securities	\$ 7,020,915	14.57 %
Federal Home Loan Bank	U.S. agency securities	5,684,851	11.80
General Electric Capital/GE Company	Corporate Bonds/Commercial Paper	3,502,883	7.27

**OTHER PRIMARY GOVERNMENT INVESTMENTS**

<u>Issuer</u>	<u>Investment Type</u>	<u>Reported Amount</u>	<u>% of Total Agency Investments</u>
<b>Golden State Tobacco Securitization Corporation</b>			
American General Finance	Commercial paper	\$ 63,450	13.84 %
Briarwood	Commercial paper	63,543	13.86
Morgan Stanley	Commercial paper	134,925	29.43
Security Benefit Life Insurance	Commercial paper	65,010	14.18
Golden Fish LLC	Commercial paper	71,061	15.50
Landesbank Baden Wurttemberg	Commercial paper	60,470	13.19
<b>California State University</b>			
Federal Home Loan Bank	U.S. agency securities	\$ 91,905	6.30 %
<b>Department of Veterans Affairs</b>			
Bayerische Landesbank	Guaranteed investment contracts	\$ 62,193	41.87 %
Societe Generale	Guaranteed investment contracts	16,440	11.07
Westdeutsche Landesbank	Guaranteed investment contracts	62,182	41.86

### 4. Custodial Credit Risk

The State of California has a deposit policy for custodial credit risk that requires that deposits held by financial institutions be insured by federal depository insurance or secured by collateral. As of June 30, 2005, \$10 million in deposits of the Electric Power Fund and \$10 million in deposits of the Water Resources Development System were held in uninsured and uncollateralized accounts with U.S. Bank.